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GUTIERREZ, AMB LGUTIERREZ

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SUBJECT: SEC GUTIERREZ LUNCH WITH LUGO'S ECONOMIC TEAM

Classified By: A/DCM John Beed; reasons 1.4 (b) and (d).

1. (C) SUMMARY: Ambassador Ayalde hosted a lunch for Secretary Gutierrez and the U.S. delegation to Lugo's inauguration and Lugo's economic team August 14. Finance Minister Borda outlined an expansive agenda of economic policy priorities: pro-growth macro-economic policies; public sector reform to improve service delivery and the quality of civil servants; reform of state-owned enterprises; competitiveness and productivity; agrarian reform; job creation; and poverty reduction. Describing Paraguay's macro-economic situation as on-track, Borda said managing short-term, high expectations related to job creation and poverty reduction will be his greatest challenge. Borda asserted that dialogue between civil society, private sector and government is the basis of sustained economic growth, but did not offer much regarding how the new government would foster this dialogue. Formalizing the economy, according to Borda, is a process that combines administrative efficiency, legal processes, and structural and human resources to promote integrated development of small and medium enterprises. Senior Advisor to Minister Borda Fernando Masi explained that MERCOSUR's statutes limit Paraguay's capacity to independently seek Bilateral Trade Agreements, and alluded to growth potential of non-traditional exports outside MERCOSUR as an opportunity for Paraguay to expand its markets. The lunch was a productive exchange, but revealed the huge challenge in implementing a broad set of reforms and showing results, and some looming tensions that could confront Lugo's economic team. END SUMMARY.

BORDA'S ECONOMIC PLAN - OPPORTUNITIES AND CHALLENGES

13. (C) Minister of Finance and head of Lugo's Economic Team Dionisio Borda, Minister of Industry and Commerce Martin Heisecke, Senior Advisor to Minister Borda Fernando Masi, Vice Minister of Economic Integration Manuel Caballero, Vice Minister of Commerce Gladys Bareiro-Modica, and Advisor to Minister Heisecke Guillermo Alcaraz attended a lunch hosted by Ambassador Ayalde for Secretary Gutierrez and U.S. delegation to President Lugo's inauguration August 14. The U.S. delegation included State PDAS Craig Kelly, NSC Director Dan Fisk, OPIC President Robert Mosbacher, and Commerce Advisor Lino Gutierrez. Acting DCM and econ officer (notetaker) also attended. Following Ambassador Ayalde's welcome, Secretary Gutierrez described a growing tendency toward pragmatism in Latin America, where leftist politics are accompanied by right-center economic policies, highlighting as an example Chile's 52 Bilateral Trade Agreements (BTAs). Secretary Gutierrez emphasized that within this pragmatism, private sector investment is central to sustained growth and employment.

14. (C) Minister Borda described his economic policy

priorities: pro-growth macro-economic policies; public sector reform to improve service delivery and the quality of civil servants; reform of state-owned enterprises; competitiveness and productivity; agrarian reform; job creation; and poverty reduction. Borda emphasized the need to reform state enterprises in key sectors (cement, oil and gas, electricity distribution, communication, and water). Borda mentioned that the reform of state-owned enterprises has been slow, and the International Monetary Fund (IMF), as part of the previous outstanding IMF stand-by agreement, did not push the former Paraguayan government for greater reform measures.

15. (C) Borda said a mixed council (private sector and government) will oversee the performance of state-owned enterprises, and signaled that private sector involvement (capitalization and public works concessions) will be key to the reform process. Borda cited the successful case of Chile with privatizing its road concessions. Borda linked Paraguay's lack of competitiveness to the inefficiency of these enterprises. Citing a USAID study, Borda indicated that poor infrastructure makes Paraguay's transportation costs appreciably higher than those of its neighbors.

16. (C) Borda said his greatest challenge will be managing short-term, high expectations related to job creation and poverty reduction. Borda explained that there is immense pressure on the Lugo administration to show results within its first 100 days. Minister Borda expressed frustration with the lack of qualified professionals in Paraguay, and inadequate government salaries to attract the few good professionals available. He said he would have to finalize the entire government budget by September 1. Borda also described the challenges in maintaining high growth rates, diversifying the economy, and finding markets outside MERCOSUR. Ambassador Lino Gutierrez asked Borda why he joined Lugo's team; Borda replied that "he is making a bet on change and wants to be part of it; he hopes for and is driven by the possibility of change."

17. (C) Borda said Paraguay's macroeconomic and fiscal policies have been solid in the past and many will continue, but mentioned two immediate challenges: the lack of flexibility in public spending and the rapid appreciation of the Guarani. With regard to competitiveness, Borda mentioned that new policies will focus on improving infrastructure and the pool of trained labor. Borda also asserted that Paraguay's competitiveness is not a function of its low taxes; he explained that even with the lowest tax structures in the region, Paraguay remains one of the least competitive economies in Latin America. He alluded to the need to raise the tax base and the tax rates for the new government to have additional resources to tackle its development agenda.

THE PRIVATE SECTOR ROLE AND ECONOMIC FORMALIZATION

18. (C) Ambassador Ayalde asked if the government would seek private sector input in the formulation of economic policies. Minister of Industry and Commerce Heisecke explained that in the past, an Inter American Development Bank program sponsored private/public sector round tables that they would continue to use. (NOTE: During an earlier meeting with members of AmCham, the representatives of U.S. firms complained about the absence of a space to allow for private sector input into formulation of economic reforms. END NOTE.) Heisecke emphasized the need to formalize the economy, to maintain clear rules for investors, and to promote the private sector, not penalize it with higher taxes. Heisecke stated that wealth creation is a private sector driven process. Calling "globalization not a threat but an opportunity," Heisecke sees clear growth potential for Paraguay in international markets. Heisecke described his agenda as growth with equality. Borda added that his economic plan envisions a close participative three-way dialogue with the private sector and civil society on the development of economic policies.

¶9. (C) Heisecke said employment in the formal economy is often less lucrative than informal avenues. Borda interjected that formalization in Paraguay is a process that needs to combine administrative efficiency, legal processes, and structural and human resources issues to promote an integrated development of small and medium enterprises (SMEs). Minister Borda used agriculture SMEs as an example. He stated that 85 percent of Paraguay's informal producers have less than 50 hectares of land, and the challenges of formalization include integrating these small producers into agro-supply value chains. Secretary Gutierrez underscored the importance of SMEs in U.S. job creation. Borda asserted that more trained labor and improved infrastructure are priorities for formalization of the economy.

MERCOSUR AND BILATERAL TRADE AGREEMENTS

¶10. (C) Secretary Gutierrez inquired about Paraguay's trade interests and the possibilities of BTAs. Senior Advisor to Minister Borda Fernando Masi explained that MERCOSUR's statutes limit Paraguay's capacity to independently seek BTAs. Masi stated that Argentina does not have any BTAs outside MERCOSUR but has trade agreements with associate member countries outside MERCOSUR, namely Chile. Masi also described how MERCOSUR statutes commit full member countries to negotiate BTAs as a block. Exceptions are possible but only for trade agreements with associate member countries. Masi alluded to growth potential of non-traditional exports outside MERCOSUR as an opportunity for Paraguay to expand its markets, and used as an example the many trade opportunities that have not been exploited under the US Generalized System of Preferences (GSP) program. Borda echoed Masi's words with an example of a Paraguayan company that started to export "mate" leaves (cold-tea leaves) to the US.

¶11. (C) When asked about Paraguay's future in MERCOSUR, Masi responded that trade among full member countries is growing, especially with Brazil, and though some bilateral agreements have been reached, Paraguay's top goal is to reach new markets outside South America. Masi indicated that Israel is the only country outside MERCOSUR with which it has a trade agreement.

OTHER ISSUES

¶12. (C) Vice-Minister of Commerce Gladys Bareiro-Modica remarked that Paraguay is signatory to the WTO TRIPS agreement and promised to work to ensure that Paraguay is in compliance with its obligations. Secretary Gutierrez remarked that piracy is a challenge for Paraguay; Heisecke agreed, due to the re-export triangulation in the tri-border. Heisecke also mentioned the counterfeiting of cigarettes as another significant challenge. According to Heisecke, an international cigarette manufacturer estimated that Paraguay has the largest installed capacity per capita for counterfeited cigarette production in the world.

¶13. (C) Secretary Gutierrez closed by encouraging Paraguay to attend next year's America Competitiveness Forum (ACF) in Chile, and also suggested the possibility of putting together a U.S. trade mission to Paraguay in the future. Secretary Gutierrez thanked participants for the positive and frank exchange, and expressed his support and willingness to collaborate, extending an invitation to participants to meet with him in Washington.

COMMENT

¶14. (C) COMMENT: The lunch was a productive exchange of ideas. Finance Minister Borda, a well-respected and former Finance Minister (2003-2005), demonstrated his command of economic policies and priorities. As Lugo's Economic Team

leader, Borda has Lugo's full support and appears to have a mandate beyond the economic arena. The exchange, however, revealed some differences and tensions between Minister Borda's and Minister Heisecke's approaches on economic policy. Borda maintained a coherent presentation with examples to highlight key aspects in his agenda, and his answers were well organized. Heisecke offered many examples of individuals and situations to justify the need for reform and economic growth, but did not discuss policy, and his answers were disorganized and generally lacked substance. At certain points during the lunch when Heisecke spoke, Borda and Masi discretely seemed to roll their eyes. Borda will lead the implementation of Lugo's economic plan in the next 100 days when the pressure for results is at its peak. Borda's plan is broad and ambitious, but well-developed. If the Lugo economic cabinet does not gel into a cohesive team under Borda, the new administration will be hard-pressed to meet the challenge of an already daunting array of challenges. END COMMENT.

¶15. Secretary Gutierrez did not have an opportunity to clear this cable before departure.

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AYALDE